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SUPREME COURT, U.S.
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No.

IN THE

Supreme Court of the United States

October Term, 1986

WILLIAM J. HARNETT,
Petitioner,

v.

TOM J. BILLMAN,
CLAYTON C. MCCUISTION,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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QUESTIONS PRESENTED

1. (a) In a district court civil action in which subject matter jurisdiction is based upon diversity of citizenship, may the district court, consistent with the constitutional and statutory mandate announced in *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), fashion a rule of decision for the federal courts that produces a different outcome from the rule that would be applied in the courts of the forum state?

(b) Specifically, after a judgment in a federal diversity action, may the district court in a subsequent diversity case apply a federal court-created principle of *res judicata* to bar the second action, where the foum state's courts would not bar the subsequent action but would afford a remedy under that state's *res judicata* principles?

2. If a "federal" principle of *res judicata* is to be applied in diversity actions, should not it be a uniform one which includes an exception for cases of fraudulent concealment by defendants?

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioner William J. Harnett prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Fourth Circuit entered on September 16, 1986.

OPINIONS BELOW

The opinion of the Court of Appeals (A1) is reported at 800 F.2d 1308 (4th Cir. 1986). The petition for rehearing was denied on October 29, 1986 (A15). The principal decision of the district court (A16) has not been published.

JURISDICTION

The judgment of the Court of Appeals was entered on September 16, 1986. A timely petition for rehearing was denied on October 29, 1986. This petition is being filed within 90 days of the denial of the petition for rehearing.

This Court has jurisdiction to review the judgment of the Court of Appeals under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This case involves the following constitutional provisions and statutes:

U.S. Constitution

Article III, Section 1. Judicial Power of the United States.

The judicial Power of the United States, shall be vested in one Supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish;

Article III, Section 2. Controversies between citizens of different states.

The judicial Power shall extend to all Cases, in Law and Equity, . . . between Citizens of different States . . . .

Title 28, United States Code, Judiciary and Judicial Procedure

§ 1332 Diversity of citizenship; amount in controversy; costs.

(a) The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of $10,000, exclusive of interest and costs, and is between—

(1) citizens of different states . . . .

§ 1652 State laws as rules of decision.

The laws of the several states, except where the Constitution or treaties of the United States or Act of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply.

STATEMENT OF THE CASE

This petition seeks review of a decision of the United States Court of Appeals for the Fourth Circuit which applied federal, instead of state, *res judicata* principles when it considered the effect of a prior federal diversity action in a subsequent diversity case between the same parties. The Fourth Circuit fashioned a

broad federal rule of claim preclusion that had the effect of barring petitioner's common law fraud claim, even though the claim would not have been barred by the law of Virginia, the forum state. The broad rule of claim preclusion adopted by the Court of Appeals "asks only if a claim made in the second action involves a right arising out of the same transaction or series of connected transactions that gave rise to the claims in the first action," irrespective of whether or not it constitutes a separate injury or cause of action under state law (A8). This rule excludes consideration of whether or not different harms are involved or different relief is sought (A10). Under Virginia law, a separate cause of action for a separate injury may be maintained although it arose out of the same series of transactions involved in the prior action.

The unresolved issues raised by this petition revolve principally around the authority of the federal courts, under both the constitutional mandate of *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), and the statutory directive of 28 U.S.C. § 1652, to fashion a rule of decision that would produce a different outcome from the rule that would be applied in the courts of the forum state. In adopting a federal *res judicata* rule for diversity cases, the Fourth Circuit's decision so deviates from *Erie* and from decisions in other circuits as to require this Court's intervention.

* * * *

This action (the "EMSI action") was brought in February, 1985 in the United States District Court for the Eastern District of Virginia by petitioner William Harnett, a shareholder of EPIC Mortgage Servicing, Inc. ("EMSI"), for damages to his EMSI shareholdings resulting, *inter alia*, from the fraudulent diversion by respondents Tom J. Billman and Clayton C. McCuistion, of EMSI's mortgage servicing business and assets to another company, EPIC Mortgage, Inc. ("EMI"), also controlled and operated by respondents. The fraud began on March 2, 1983 when EMSI shares were spun off from EMI, a mortgage banking subsidiary of Equity Programs Investment Corporation ("EPIC"), to the shareholders of EPIC (including petitioner), in order that a separate corporate entity perform

the mortgage servicing business previously conducted by EMI. (A19-23). Petitioner, Chairman of Washington, Homes, Inc., was an original investor in EPIC and, by March 1983, the only remaining minority shareholder. Respondents owned more than 90% of EPIC stock. Shortly after the spin-off of EMSI, respondents began diverting this business back into EMI, an EPIC subsidy, after petitioner had lost his stock interest in EPIC as a result of a merger. This fraudulent diversion of EMSI's business continued until November 1984, when EMSI underwent a statutory short form merger with yet another company controlled by respondents, freezing out petitioner as an EMSI shareholder (A23). Throughout EMSI's existence, the diversion of its business to EMI was concealed from petitioner (A23-24). By the time EMSI was merged out of existence, it was a virtual shell with few assets and no business operations. EMSI never performed any mortgage servicing work (A22-23).

The EMSI action was tried to the district court on September 17 and 18, 1985. On October 7, 1985, the district court entered judgment in petitioner Harnett's favor for actual and punitive damages against the individual respondents (A28). Petitioner established by clear and convincing evidence that respondents had committed common law fraud by engaging in a twenty-month scheme to conceal from him the material fact that EMSI's business and assets had been diverted to EMI in order to eliminate petitioner's interest in that business. The district court further held that respondents fraudulently misrepresented to petitioner that the EMSI spin-off would be tax-free when, in fact, it was not, because EMSI was not an active trade or business. The district court's judgment was modified on November 1, 1985 to increase the amount of compensatory damages (A29).

In October, 1983, petitioner had brought a diversity action in the Eastern District of Virginia as a shareholder of EPIC (the "EPIC Action").[1] Petitioner had sued for damages to his EPIC shareholdings resulting from non-disclosures in connection with the March 15, 1983 merger of EPIC and Community Savings &

[1] *Harnett v. Billman, et al.*, Civil Action No. 83-1029-A (E.D. Va. 1984).

Loan, Inc., a Maryland company also controlled by respondents. Respondents were defendants in that action as well. That action was dismissed with prejudice in February, 1984 pursuant to a settlement agreement whereby petitioner would be permitted to have the value of his EPIC stock determined in an appraisal proceeding in the Virginia state courts and, in the course of that proceeding, to raise any of the issues asserted in the federal action bearing on the value of his EPIC stock.[2]

The fraudulent diversion of EMSI's business was not raised in petitioner's prior EPIC action (A23). Nor was the claimed misrepresentation of a tax-free EMSI spin-off raised in the EPIC action. The sole allegation raised in the EPIC action that related to EMSI was that the amount of stock that petitioner received in the EMSI spin-off was less than he was entitled to because his percentage stock interest in EPIC previously had been diluted (A23). However, no damages to petitioner's EMSI shareholdings were claimed. Because it was settled and dismissed, petitioner's earlier action was never adjudicated on the merits.

The fraudulent diversion of EMSI's business which forms the basis of this case occurred both before and after the earlier action was dismissed, and it was concealed from petitioner even after the settlement and dismissal of that first suit (A23). Petitioner did not discover that EMSI's business had been diverted until he received notice of the short form merger of EMSI in November 1984, which notice was accompanied by financial information showing that EMSI's business and assets had been depleted (A23). Petitioner then commenced this second diversity action in the Eastern District of Virginia in February 1985 against respondents, EMI and certain other corporate defendants, seeking damages caused to his EMSI stock interest in several claims for relief.

Judge Albert V. Bryan, Jr., the same district judge who had dismissed petitioner's earlier action, heard several motions by

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[2] Petitioner's EPIC appraisal proceeding is currently pending in the Circuit Court of Fairfax County, Virginia. *Harnett v. Equity Programs Investment Corporation,* In Chancery No. 95800.

the defendants in this action raising the *res judicata* effect of that prior judgment. The district court agreed that certain of petitioner's claims in the EMSI action relating to the dilution of stock were barred by its order dismissing the earlier action, but held that petitioner's claim based on respondents' fraudulent concealment of the diversion of EMSI's business was not barred by *res judicata* (A23). During pre-trial motions, and again in a post-trial motion, the district court found that the facts relating to the claim of diversion of EMSI's business (1) were not known by petitioner until November 1984, (2) could not reasonably have been raised in the prior action because respondents continued to conceal the fraud, and (3) were based upon a different transaction and a different stock interest than those asserted in the earlier suit (A23, 30-31, 32-33).

Respondents appealed from the judgment against them on the common law fraud count.[3] The Court of Appeals reversed the district court's judgment and held that petitioner's claim was barred under a federal rule of *res judicata* which, the court acknowledged, would likely produce a different result from that which would occur in the Virginia state courts. Essentially the Court of Appeals held that, absent a strongly expressed state policy, *res judicata* principles applicable in federal courts should be fashioned by the federal courts, even in diversity cases.

REASONS FOR GRANTING THE WRIT

Introduction

Among the many important cases competing for this Court's attention, this case stands out in its significance to the administration of civil justice in the federal court system, for the following reasons:

1. By formulating a federal common law principle of *res judicata* instead of applying that of the forum state, the

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[3] Petitioner Harnett cross-appealed from the district court's dismissal of other claims, including federal securities laws claims and breach of fiduciary duty claims, for failure to state claims upon which relief could be granted.

Court of Appeals ignored the Rules of Decision Act, 28 U.S.C. § 1652 (1966), and circumvented the constitutional mandate and jurisprudential policies underlying *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938). Through *Erie* and its progeny, this Court has implemented core policies of federalism that govern the interrelationship between the state and federal judiciaries. The Court of Appeals' decision undermines the goals of *Erie* by virtually ensuring inequitable administration of the laws, as well as forum shopping. Had petitioner brought his fraud claim in a Virginia court, the Virginia law of *res judicata* would have permitted him relief on the merits. Application of the federal principle is thus outcome-determinative in the most severe sense—the effect of the Fourth Circuit's decision is to prevent redress for perpetration of a serious fraud where the Virginia courts would have granted relief.

2. The Courts of Appeals are sharply divided over the issue of whether state or federal preclusion principles apply in a subsequent diversity suit. This Court should definitively answer such an important question of judicial administration and competence rather than leave it to *ad hoc* determination in each circuit.

3. If a federal rule of *res judicata* should apply in successive diversity cases, this Court should establish a uniform rule to guide all federal courts, and explain the scope as well as the source of such a rule. Otherwise, the district courts will apply varying principles and theories of claim preclusion.

4. If such a federal rule applies, it should include the well-established concealment exception to all *res judicata* principles. A plaintiff cannot be expected to merge all related causes of action into one lawsuit when the defendants intentionally and fraudulently have concealed information that would notify him that a related claim exists. Here, petitioner's claims are based on two separate transactions. The latter transaction involved an ongoing fraud which, due to respondents' concealment, petitioner could

not have discovered until after the first lawsuit was dismissed. Petitioner should not be denied recovery, then, regardless of which principle of *res judicata* is applied.

For all of these reasons, as amplified below, this Court's review is necessary.

I. THE COURT SHOULD REVIEW THIS CASE BECAUSE THE DECISION OF THE COURT OF APPEALS OFFENDS THE CONSTITUTIONAL HOLDING OF *ERIE* AND VIOLATES THE RULES OF DECISION ACT, AND BECAUSE THE COURTS OF APPEALS ARE SHARPLY DIVIDED ON THE ISSUE

Despite the teachings of *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), and the Rules of Decision Act, 28 U.S.C. § 1652, the United States Court of Appeals for the Fourth Circuit held that a federal common law of *res judicata* should be applied in this diversity action to preclude a claim which would not have been precluded under the *res judicata* rules of Virginia, the forum state. In so doing, the Fourth Circuit joined the minority of the sharply divided circuits on this question. Only review by this Court can resolve this conflict of circuits and restore the vigor of *Erie* on this important question.

The conflict of circuits on this issue is deep and serious. Including the present case, seven circuits have addressed the issue of federal versus state *res judicata* rules in successive diversity actions. The majority have decided that, in accordance with *Erie* and its progeny, state law applied because principles of *res judicata* are intricately related to the state-created rights and obligations which comprise the substance of federal diversity actions, while the minority have viewed this merely as a question of federal procedure.

Specifically, four circuits have applied state law in this situation. *See Answering Service, Inc. v. Egan*, 728 F.2d 1500 (D.C. Cir. 1984); *Semler v. Psychiatric Institute*, 575 F.2d 922 (D.C. Cir. 1978); *Gasbarra v. Park-Ohio Industries*, 655 F.2d 119 (7th Cir. 1981); *Hayles v. Randall Motor Co.*, 455 F.2d 169 (10th Cir. 1971); *Makariw v. Rinard*, 336 F.2d 333 (3d Cir.

1964). However, two circuits beside the Fourth have applied federal preclusion laws in the context of successive diversity actions. *See Precision Air Parts v. Avco Corp.*, 736 F.2d 1499 (11th Cir. 1984) (following pre-division Fifth Circuit rule), *cert. denied*, 469 U.S. 1191 (1985), *Commercial Box & Lumber Co. v. Uniroyal, Inc.*, 623 F.2d 371 (5th Cir. 1980).

Moreover, the Fourth Circuit resolution is incorrect. Almost fifty years ago, in *Erie*, Justice Brandeis wrote that the federal courts have no constitutional power to create a federal rule of decision to apply in a diversity case seeking to enforce state created rights. *Erie* similarly established that the Rules of Decision Act requires that state rules of decision govern the rights and obligations of parties in a diversity action. In addition to bringing the federal courts into compliance with constitutional and statutory requirements, *Erie* also served the interest of assuring comity, consistency and uniformity between state and federal courts that are adjudicating identical claims, preventing forum shopping and unseemly litigation gamesmanship.

The First Congress passed the Rules of Decision Act to ensure that civil remedies fashioned by a state's legislature and courts would be equally respected and enforced by federal courts adjudicating state-based claims, so that different results do not obtain for the same claim merely in consequence of the accident of the parties' citizenship. *Erie*, and the line of cases subsequent to *Erie*, have invoked and evolved these fundamental principles in varying contexts to ensure that common law remedies in diversity actions are applied in an equitable fashion regardless of the parties' citizenship. *See Erie*, 304 U.S. at 75; *Klaxon v. Stentor Electric Manufacturing Co.*, 313 U.S. 487, 496 (1941). As stated in *Guaranty Trust Co. v. York*, 326 U.S. 99, 109 (1944), *Erie* "expressed a policy that touches vitally the proper distribution of judicial power between the state and federal courts."

Since *Erie*, these concerns have led this Court to require the application in diversity actions of a state statute of limitations, *Guaranty Trust*, 326 U.S. 99, state rules governing burdens of proof, *Cities Service Oil Co. v. Dunlap*, 308 U.S. 208

(1939), state principles of conflicts of laws, *Day & Zimmerman, Inc. v. Challoner*, 423 U.S. 3 (1975); *Klaxon*, 313 U.S. at 487, state security for costs statutes, *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541 (1949), and state rules determining the timing of commencement of an action for statute of limitations purposes, *Walker v. Armco Steel Corp.*, 446 U.S. 740 (1980).

In these cases this Court rejected formalistic distinctions between "substantive" and "procedural" rights. Whether a state law is labeled substantive or procedural, a federal court must apply it if it sets forth a right or policy intimately bound up in the state remedy. *Erie* "was not an endeavor to formulate scientific legal terminology." *Guaranty Trust*, 326 U.S. at 109.

Erie and subsequent decisions were intended to discourage forum shopping by eliminating the possibility that a choice of forum would depend on whether federal or state common law is more favorable, and to avoid inequitable administration of the law solely because of the parties' citizenship. *Hanna v. Plumer*, 380 U.S. 463, 467 (1964).

In determining whether the application of federal common law would encourage forum shopping or inequitable administration of the law, the courts consider whether the application of federal common law to a plaintiff's claims would result in a different outcome than if a state rule was applied. "The Erie rule is rooted in part in a realization that it would be unfair for the character or result of a litigation materially to differ because the suit had been brought in a federal court." *Id.* Accordingly, federal judges have fashioned a federal rule only where an overriding federal interest compels them to do so, *see, Byrd v. Blue Ridge Rural Electric Cooperative*, 356 U.S. 525 (1958),[4]

[4] In *Byrd*, 356 U.S. at 537, this Court held that affirmative countervailing federal interests in complying with the Seventh Amendment of the United States Constitution compelled the application of a federal rule so that a jury rather than a judge would decide questions of fact. Since *Byrd*, the Courts of Appeals have divided over whether to apply a state or federal law test to determine the sufficiency of evidence to create a jury question. *Compare Wielock v. Rogers Cartage Co.*, 290 F.2d 235 (7th Cir. 1961), *with Boeing Co. v. Shipman*, 411 F.2d 365 (5th Cir. 1969).

or where Congress has validly enacted a governing procedural rule. *Hanna*, 380 U.S. 463.

The Fourth Circuit's decision directly contravenes these constitutional, statutory and policy mandates by creating a federal principle of *res judicata* applicable to the adjudication of a diversity claim based purely on state common law. As a consequence, substantive rights that would have been enforced in Virginia's courts were precluded in a federal court. In the face of *Erie's* reminder that there is no such thing as general federal common law, and no constitutional power in federal courts to create local law, the Fourth Circuit has plucked from the air a federal common law of claim preclusion that alters and removes a state-created remedy.

The scope and effect of a prior ruling is fundamentally bound up with the interpretation and adjudication of state rights and obligations, and with the enforcement of state-imposed remedies for violations of those rights. In Virginia, as in most states, the doctrine of *res judicata* has been expressly recognized as a part of the state's "public policy" concerning what rights are judicially cognizable in that state's courts. *Bates v. Devers*, 214 Va. 667, 202 S.E.2d 917 (1974). It is not surprising, then, that the majority of Courts of Appeals which have ruled on the question have invoked the policies underlying *Erie* to apply state *res judicata* principles to determine the effect of a prior federal diversity action.

In this case, however, the Fourth Circuit applied what it perceived to be a federal common law of *res judicata* to bar all claims related to the transactions which were the subject of the earlier litigation. It did so despite the consequent disparity in outcome which offends the objectives of *Erie* to avoid forum-shopping and inequitable administration of the law. The *res judicata* law of Virginia, the forum state, would not have barred petitioner's fraud claim.[5] The court itself acknowledged that a

[5] Virginia's *res judicata* law bars subsequent claims only if they give rise to the same cause of action as the claims in the initial lawsuit. *Bates*, 214 Va. 667; *Carter v. Hinkle*, 189 Va. 1, 52 S.E.2d 135 (1949). "Cause of action" for these purposes, is defined by the Virginia courts as an assertion of local rights which have risen out of a single definable factual transaction. *Allstar Towing v. Alexandria*, 231 Va. 421, 425, 344 S.E.2d 903 (1986), citing *Bates*, 214 Va. at 672 n.8.

different outcome would have resulted if Virginia preclusion law had been applied (A7).

In creating a federal principle of *res judicata*, the Fourth Circuit inquired as to whether any affirmative state policies dictated a contrary result (A8). This mode of analysis, however, is precisely the converse of what this Court mandated in *Byrd*, where the state rule was held to be applicable unless there was an overriding and substantial *federal* interest in applying federal common law.[6] *Byrd*, 356 U.S. at 537.

The Court of Appeals' decision undermines the forum state's ability to enforce its common-law anti-fraud laws. It thus offends and frustrates state-created remedies. The decision below also encourages the very kind of forum-shopping and procedural tactics that *Erie* found so objectionable. *See Black & White Taxicab Transfer Co. v. Brown & Yellow Taxicab & Transfer Co.*, 276 U.S. 518 (1928).

The question of which *res judicata* principle to apply in successive diversity actions is critical to the efficient management and administration of diversity litigation. The effect of one federal court's judgment on a subsequent federal diversity action goes to the heart of the federal courts' function to administer justice equitably and influences the smooth operation of the federal judiciary. Accordingly, it is crucial that all federal courts resolve the issue uniformly. *See Textile Workers Union of America v. Lincoln Mills of Alabama*, 353 U.S. 448, 449 (1957).

Forty-nine years have passed since *Erie*, and this fundamental question of judicial administration and competence remains disputed and has not been settled by this Court. It is necessary, in the interest of the administration of justice by the federal judiciary, for this Court now to settle the issue.

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[6] Indeed, the Fourth Circuit itself had previously held both that state procedural rules "intimately bound up with the state right or obligation" are constitutionally controlling, and that even if a state rule is not an integral part of the remedy, it controls "unless there are affirmative countervailing federal considerations." *Szantay v. Beech Aircraft Corp.*, 349 F.2d 60 (4th Cir. 1965).

II. IF A FEDERAL COMMON LAW PRINCIPLE OF *RES JUDICATA* SHOULD APPLY TO SUCCESSIVE DIVERSITY ACTIONS, THIS COURT SHOULD ESTABLISH A UNIFORM PRINCIPLE, INCLUDING A RULE THAT A CLAIM RAISED IN THE SUBSEQUENT LAWSUIT SHOULD NOT BE PRECLUDED IF PLAINTIFF WAS UNAWARE OF ITS EXISTENCE DUE TO DEFENDANTS' FRAUDULENT CONCEALMENT

Through their diversity jurisdiction, the federal district courts adjudicate state-created claims and remedies. This case, therefore, poses the fundamental question of whether the scope of the federal courts' power includes the authority to formulate federal rules that govern the preclusive effects of a prior federal diversity judgment. If the grant of diversity jurisdiction was intended to encompass the power to formulate a federal common law of *res judicata*, then such a significant determination ought to issue from this Court. A rule of law such as *res judicata* does not spring Venus-like from nowhere. Claim preclusion rules are not uniform. Some jurisdictions, like Virginia, focus on the cause of action or specific claim; others broadly preclude any claim generally related to a transaction which was the subject of a previously decided claim. Only this Court can define the scope of a federal *res judicata* rule.

In this case, the Court of Appeals overlooked a fact-finding of fundamental importance by District Judge Bryan (who presided over both actions initiated by the petitioner), namely, that petitioner could not have discovered the fraudulent transactions at issue in the second action until after the first action was dismissed (A23).

The first action, in which petitioner requested damages to his EPIC shareholdings resulting from non-disclosures in connection with the merger of EPIC and Community Savings & Loan, was instituted in October, 1983 and dismissed by a settlement in February 1984. Although the fraudulent diversion of EMSI's business had begun in 1983, respondents were successful at concealing their fraud from petitioner until November, 1984. He instituted the second action in federal district court in February, 1985. Judge Bryan, fully versed in all

the facts surrounding both actions, decided that the doctrine of *res judicata* did not preclude the second action for two reasons. First, he held that the two claims involved two separate transactions and stock interests; the fraud surrounding the diversion of EMSI's business was distinct from the claimed non-disclosures surrounding EPIC's merger with Community, and was therefore actionable regardless of the first dismissal with prejudice. Second, Judge Bryan recognized that fraudulent concealment of information was an essential component of the respondents' fraudulent diversion of business from EMSI. He refused to penalize petitioner for respondents' success in concealing information that would have led to his discovery of an additional claim, and therefore refused to bar the second action.

Petitioner should not be denied recovery even if a federal common law principle of *res judicata* is applied. A fundamental injustice occurred when the Court of Appeals overlooked the fraudulent concealment aspect of Judge Bryan's opinion. The federal law of *res judicata* should recognize the universal principle that claims which were unknown to plaintiffs at the time of their earlier suits cannot be barred. *See Restatement (Second) of Judgments* § 26, comment j (1981); *McCarty v. First of Georgia Insurance Co.*, 713 F.2d 609, 612-13 (10th Cir. 1983). Any other rule will bar actions which, as a matter of fact, could not have been brought at the time of the initial litigation. Such a rule is neither just nor in keeping with general common law principles. It should not be the federal rule.

CONCLUSION

For each and all of the foregoing reasons, a writ of certiorari should be granted.

Respectfully submitted,

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OPINION OF COURT OF APPEALS.
September 16, 1986

United States Court of Appeals

FOR THE FOURTH CIRCUIT

No. 85-2338

WILLIAM J. HARNETT,
Appellee,

versus

TOM J. BILLMAN; CLAYTON C. MCCUISTION,
Appellants,

and

EPIC MORTGAGE, INC., a Delaware corporation; CAVALIER OIL CORPORATION, a Delaware corporation; EPIC REALTY SERVICES, INC., a Delaware corporation,
Defendants.

No. 85-2339

WILLIAM J. HARNETT,
Appellant,

versus

TOM J. BILLMAN; CLAYTON C. MCCUISTION,
Appellees,

and

EPIC REALTY SERVICES, INC., a Delaware corporation,
Defendants.

Appeal from the United States District Court for the Eastern District of Virginia, at Alexandria. Albert V. Bryan, Jr., Chief District Judge. (C/A 85-157)

Argued July 14, 1986. Decided September 16, 1986

Before RUSSELL, PHILLIPS, and CHAPMAN, Circuit Judges.

John R. Fornaciari (Robert M. Disch; Steele, Simmons & Fornaciari on brief) for Appellants/cross Appellees, Billman and McCuistion; Thomas Earl Patton (Brett L. Antonides; Louis R. Moffa, Jr.; Schnader, Harrison, Segal & Lewis; John E. Harrison; Light & Harrison, P.C. on brief) for Appellee/cross Appellant.

PHILLIPS, Circuit Judge:

Tom Billman and Clayton McCuistion appeal from the district court's judgment, after a bench trial, awarding William Harnett more than $60,000 in compensatory damages and $35,000 in punitive damages on his claims of common-law fraud. Harnett has cross-appealed from orders of the district court granting summary judgment against some of his claims on res judicata grounds and dismissing other claims based on federal and state securities law violations and on alleged breaches of fiduciary duty. We conclude that Harnett's fraud claims, as well as much of the securities and fiduciary duty claims upon which he did not prevail, were subject to the bar of a prior judgment involving these same parties. We also hold that to the extent that Harnett's securities and fiduciary duty claims survived the prior judgment, they were properly dismissed because, as a matter of law, Harnett could not prevail on these claims. We therefore reverse the judgment in favor of Harnett on his fraud claim and affirm the dismissal of his other claims.

I

In 1975, Harnett purchased 1,250 shares of the Equity Programs Investment Corporation (EPIC) for $5,000. By 1983, Billman and McCuistion together owned more than 90% of EPIC's shares. Over the years, EPIC had become the parent corporation of a number of subsidiaries, including EPIC Mortgage, Inc. (EMI) and EPIC Realty Services, Inc. (ERSI).

In June 1982, ERSI became an independent corporation in a spin-off transaction, and a separate spin-off from EMI led to the creation of EPIC Mortgage Servicing, Inc. (EMSI) on March 1, 1983. Harnett received shares in both of the new companies equal to what the defendants represented was his proportion of ownership in EPIC. In December 1984, ERSI was absorbed in a Delaware short form merger by Realty Services Holdings, Inc., and in November 1984, EMSI was similarly merged into Cavalier Oil Corp. (Cavalier). Billman and McCuistion are the principal shareholders of Cavalier. A short form merger permits the "freezing out" of minority

shareholders. Harnett had received stock in ERSI and EMSI when they were spun off, but was frozen out in the short form mergers.

After the spin-offs of ERSI and EMSI, Harnett still remained a shareholder in the original EPIC corporation. In early 1983, however, EPIC and its EMI subsidiary were purchased by Community Savings and Loan, Inc. (CSL), a Maryland-chartered savings and loan association. Billman and McCuistion also owned a controlling interest in CSL. In January 1983, Harnett received a notice seeking the approval by EPIC's shareholders of a merger of EPIC into a CSL subsidiary. EPIC shareholders were to receive non-voting preferred CSL stock. For various reasons, most apparently relating to the nature of the stock he would receive, Harnett was unsatisfied with the merger plan. By February 1983, Harnett had become the sole remaining minority shareholder of EPIC. Harnett refused Billman's offer to purchase Harnett's shares in EPIC.

The merger of CSL and EPIC was consummated on March 14, 1983. Prior to the merger, the principal business of EMI consisted of mortgage servicing, but because for accounting reasons the servicing portfolio then owned by EMI would not be fully reflected on the books of the new CSL/EPIC conglomerate, EMI's existing servicing portfolio became the primary asset of the new spin-off from EMI, EMSI. EMI and EMSI entered into a sub-servicing agreement, dated March 1, 1983, under which EMI performed for a fee the servicing work for mortgages in EMSI's portfolio. After the EPIC/CSL merger, EMI also became the servicer, and itself owner of the servicing rights, of new mortgages originated through the new EPIC/CSL entity. EMSI, which was a company now independent of the EPIC/CSL group, did not receive any of the new servicing business, but retained only the servicing rights in its portfolio at the time of its spin-off from EMI.

In October 1983, Harnett filed an action, which we will refer to as *Harnett I*, in the United States District Court for the Eastern District of Virginia. The amended complaint in *Harnett I* alleged claims for common-law fraud, for state and

federal securities fraud, and under RICO, as well as a shareholder derivative claim. These claims centered around Harnett's allegations that Billman and McCuistion made fraudulent misrepresentations or omissions in conversations and correspondence to him in late February and early March 1983, that the documents received by Harnett in connection with the EPIC/CSL merger did not make adequate disclosures, and that Billman and McCuistion had misappropriated, through employee stock options and assignments from other shareholders, shares of EPIC. Paragraph 49(h) of the amended complaint in *Harnett I* stated that "[d]efendants, and each of them, failed to disclose to Harnett that prior to the merger of EPIC into CS&L Service Co. EPIC would spin off its mortgage servicing operation, including escrow account balances, to a new corporation."

Harnett engaged in extensive discovery in *Harnett I*, and his document production requests in that earlier litigation included requests for the records of EMSI, as well as of other companies connected to EPIC. Ultimately, pursuant to a settlement that permitted Harnett to pursue state appraisal rights in state court, *Harnett I* was dismissed with prejudice in February 1984.

Harnett was subsequently frozen out of his interests in ERSI and EMSI, and commenced the instant action in the district court in February 1985. The complaint in this case alleged claims under federal and state securities acts, for common-law fraud, and for breaches of fiduciary duty by Billman and McCuistion. The acts that form the predicate for these claims included the dilution of Harnett's interest in the ERSI and EMSI spin-off companies by virtue of the misappropriation of EPIC stock by Billman and McCuistion, alleged misrepresentations to Harnett that the new EMSI company would receive the benefit not only of EMI's existing mortgage servicing business but also that generated by future mortgages originated through the EPIC/CSL group, the execution of an EMI/EMSI sub-servicing agreement, and the alleged concealment from Harnett of the true fact that EMI, and not EMSI, was receiving the servicing business on new mortgages originated through EPIC/CSL.

Following motions for summary judgment by the defendants in this case, the district court dismissed on res judicata grounds Harnett's claims relating to share misappropriations, dismissed the securities law claims as not arising out of "the purchase or sale of securities," and dismissed the fiduciary duty claim because Harnett, who was no longer a shareholder of ERSI or EMSI, had no standing to make a derivative claim. The district court refused, however, to dismiss Harnett's common-law fraud claims relating to the EMSI spin-off and the alleged misrepresentations about the allocation of servicing work between EMI and EMSI.

After discovery, the case proceeded to a bench trial. The district court found in favor of Harnett, crediting Harnett's testimony that Billman and McCuistion represented an original intention that EMSI would receive all future mortgage servicing originated by the EPIC/CSL entity, but had failed to inform Harnett when this representation was no longer the true state of affairs. The court found that Harnett had reasonably relied to his detriment upon the misrepresentations by Billman and McCuistion, and awarded compensatory damages in excess of $60,000 and punitive damages of $35,000. The compensatory award was arrived at by calculating the amount Harnett would have received for his EMSI stock if EMSI had, in fact, done the servicing work retained by EMI. These appeals followed.

II

The principal argument advanced by Billman and McCuistion on appeal is that the district court should have dismissed Harnett's fraud claims, as well as the other claims that were dismissed for other reasons, as barred by the prior judgment entered in *Harnett I*. Res judicata precludes the assertion of a claim when "a judgment on the merits [in a prior suit] bars further claims by parties or their privies based on the same cause of action." *See Montana v. United States*, 440 U.S. 147, 153 (1979); *Nash County Board of Education v. Biltmore Co.*, 640 F.2d 484, 486 (4th Cir. 1981); *see also Adkins v. Allstate Insurance Co.*, 729 F.2d 974, 976 (4th Cir. 1984).

There is no question but that the final judgment entered in *Harnett I* is "a judgment on the merits" involving the same "parties or their privies" as those involved in the instant case.

The agreed dismissal of *Harnett I* binds the parties to that litigation, and each of the parties in this case was a named party or privy to a party in *Harnett I*. Although Harnett's complaint in this case names some different corporate entities than those named in the earlier litigation, the principal parties in each action were Harnett, Billman, McCuistion, and corporations that Billman and McCuistion controlled and of which Harnett was a present or former shareholder.

Harnett argues, however, that his claims in this case escape the preclusive effect of the judgment in *Harnett I* because the claims made in the two lawsuits are not the same claims for res judicata purposes, and because, as regards the EMSI fraud claim, he did not know of the existence of the allegedly fraudulent behavior at the time the judgment in *Harnett I* was entered. We conclude, however, that most of the claims made by Harnett in this case are barred by the judgment entered in *Harnett I*, and that the district court improperly failed to enter summary judgment for defendants on this basis.

We first address the question whether the res judicata effect to be given the judgment in *Harnett I* is a matter of federal or state law.[1] We conclude that whether a federal court

[1] The parties have not raised this issue. In many cases, the issue whether state or federal law governs a res judicata question arising out of a prior judgment entered by a federal court sitting in diversity is irrelevant, for often the state and federal rules on judgment will coincide. *See* 18 C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure* § 4472, at 735-36 & n.28 (1981 and Supp. 1986). It is not clear to us that such is the case here, however, and although we do not attempt to determine what effect a judgment entered by a Virginia federal court would have if Virginia claim preclusion law were to be applied, we note the possible divergence of federal and state judgment rules on the critical matter of the breadth of claim preclusion. *Compare Restatement (Second) of Judgments* § 24(1) (claims precluded are those arising out of the same transaction or series of connected transactions, and are precluded even if they constitute separate "causes of action"), *with Bates v. Devers*, 202 S.E.2d 917, 920 (Va. 1974) (res judicata applies only to claims arising out of "same cause of action"); *Carter v. Hinkle*, 52 S.E.2d 135 (Va. 1949) (because separate causes of action exist for personal injury and property damage arising out of same automobile accident, judgment on one cause of action does not preclude litigation of second).

sits in diversity or has some other basis of jurisdiction, questions of the effect and scope of its judgment involve the power of the federal tribunal itself, and are not varied merely because state rules of decision underlie the judgment. *See Restatement (Second) of Judgments* § 87 (1982); C. Wright, *Law of Federal Courts* § 100A, at 695-96 (4th ed. 1983) (advocating this rule, and approving of Restatement position). *But cf. Restatement (Second) of Judgments* § 87 comment b (federal courts should adopt state law to determine preclusive effect when issue involves "considerations going to stability of legal relationships," such as privity); *Spiker v. Capitol Milk Producers Cooperative, Inc.*, 577 F. Supp. 416, 418-19 (W.D. Va. 1983) (applying this exception in case where privity at issue). In this case, where the application of res judicata rules does not touch upon an important question of state law such as privity, we will apply federal rules of decision to measure the preclusive effect of the judgment in *Harnett I*.

Having decided that federal res judicata law determines the effect of the judgment in *Harnett I*, we look to Harnett's contentions that res judicata principles do not apply to his claims in this litigation. In its opinion on the merits of this case, the district court observed that Harnett's EMSI fraud claim could not be subject to res judicata because the failures of the defendants to abide by alleged promises to channel new servicing business to EMSI were "not known [by Harnett] to be misrepresentations at the time" of the dismissal of *Harnett I* in February 1984. The district court therefore reasoned that because Harnett did not know of the actual division of servicing business between EMI and EMSI until he received notice of the freeze out merger of EMSI in November 1984, the fraud claim alleged in this case could not have been the subject of *Harnett I*, and thus could not be precluded by the judgment in that action.

Actual knowledge of a potential claim is not a requirement for application of the rules of merger and bar, however; rather, the appropriate inquiry is whether the new claim arises out of the same transaction or series of transactions as the claim resolved by the prior judgment. *See Restatement (Second) of*

Judgments § 24(1) (1982). For purposes of res judicata, it is not necessary to ask if the plaintiff knew of his present claim at the time of the former judgment, for it is the existence of the present claim, not party awareness of it, that controls. This principle distinguishes from this case those cases where the challenged claim did not exist at the time of the prior litigation, *see, e.g., Lawlor v. National Screen Service Corp.*, 349 U.S. 322 (1955). Here, the record is clear that at the time of the judgment in *Harnett I*, the alleged diversion of servicing business away from EMSI had already taken place.

An exception to the general principle that lack of knowledge will not avoid the application of res judicata rules is found in cases where fraud, concealment, or misrepresentation have caused the plaintiff to fail to include a claim in a former action. *See Restatement (Second) of Judgments* § 26 comment *j*. Nevertheless, although Harnett alleged that the defendants' fraud in this case included concealment of the actual business of both EMI and EMSI, Harnett cannot assert that the concealment was such that it prevented his raising these fraud claims as part of *Harnett I*. Harnett sought and obtained discovery in *Harnett I* of the business records of EMI and EMSI to the date of that litigation, so he necessarily received information enabling him to conclude both that EMI was servicing mortgages and that EMSI's servicing portfolio had not expanded beyond that which it held at the time of its spin-off from EMI in early 1983. Moreover, Harnett possessed a copy of the EPIC/CSL consolidated annual report, dated March 31, 1983, which disclosed the spin-off of EMSI, mentioned that EMSI received in the spin-off the "existing mortgage servicing operations of EPIC," and indicated that EPIC might enter into sub-servicing agreements with EMSI. The financial statement unambiguously indicated that EMI was continuing to engage in mortgage servicing, a fact thoroughly inconsistent with the purported representations of Billman and McCuistion to Harnett that EMI would turn over its future servicing business to EMSI. In view of discovery material made available to Harnett in *Harnett I*, as well as this report received by Harnett prior to commencing *Harnett I*, it is impossible to say that any concealment or fraud by Billman and McCuistion, even if they

existed, acted to prevent the assertion of Harnett's EMSI fraud claim during the pendency of *Harnett I*.

Harnett is therefore subject to the general principle that the judgment in *Harnett I* extinguishes any claims that might have been raised in that litigation and that are, for res judicata purposes, the same claims as those advanced in the earlier case. Res judicata precludes the litigation by the plaintiff in a subsequent action of claims "with respect to all or any part of the transaction, or series of connected transactions, out of which the [first] action arose." *Restatement (Second) of Judgments* § 24(1) (1982); *Adkins v. Allstate Insurance Co.*, 729 F.2d 974, 976 (4th Cir. 1984) (embracing Restatement rule).

Harnett argues that because the claims he raised in this litigation were not for the identical injuries and remedies that were the subject of *Harnett I*, they should not be precluded. The rule of claim preclusion we apply, however, asks only if a claim made in the second action involves a right arising out of the same transaction or series of connected transactions that gave rise to the claims in the first action. To decide this, we measure the scope of "transaction or series of connected transactions" by considering pragmatic factors such as common origin and relation, as well as whether the act giving rise to the claim would be considered as part of the same unit by the parties in their business capacities. *See Restatement (Second) of Judgments* § 24(2) (1982). Claims may arise out of the same transaction or series of transactions even if they involve different harms or different theories or measures of relief. *Id.* comment *c*.

Analysis under this transactional test reveals that virtually all the claims that Harnett now raises are precluded by the judgment entered in *Harnett I*. Harnett set out seven "claims for relief" in his complaint below. The first claim, arising under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (1982) and Rule 10b-5, 17 C.F.R. § 240.10b-5, alleged securities fraud in connection with the ERSI and EMSI spin-offs and with the freeze out mergers involving ERSI and EMSI in November and December of 1984. The second claim, under

§ 17(a) of the Securities Act of 1933, 15 U.S.C. § 77(q) (1982), and the third claim, under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77(*l*) (1982), made claims relating solely to the ERSI and EMSI spin-offs. Harnett's fourth and fifth claims alleged violations of Delaware and Virginia securities laws arising out of both the spin-offs and the freeze out mergers.

In *Harnett I*, Harnett alleged that prior to the ERSI and EMSI spin-offs, Billman and McCuistion had illegitimately obtained EPIC stock to which they were not entitled. In Paragraph 45 of his complaint in the prior action, Harnett alleged that:

> This assignment of shares and/or option to Billman and McCuistion diluted the value of Harnett's interest in EPIC both with respect to the purported merger of EPIC into CS&L Service Co. as well as with respect to EPIC's spin-off of EPIC Realty Services, Inc. and EPIC Mortgage Servicing, Inc.

Harnett's securities claims in this case are based on his assertions that he was damaged in his interests in ERSI and EMSI by the misappropriation of shares, that in both the ERSI and EMSI spin-offs defendants misrepresented the number of EPIC shares outstanding, that at the time of the freeze outs these misrepresentations were continued, and that the defendants misrepresented, in connection with the EMSI spin-off, the nature of the servicing business to be received and conducted by EMSI. The complaint in *Harnett I*, however, made the claim relating to the dilution of Harnett's interest in EMSI and ERSI, and that claim is precluded from litigation here as part of Harnett's federal or state securities law claims. Moreover, as we concluded above, all of the essential elements of the claim that Billman and McCuistion had misrepresented the nature of EMSI's future business operations existed at the time *Harnett I* was dismissed, and because that claim arises directly out of the EPIC/CSL merger and EMSI spin-off that were an integral part of Harnett's claims in *Harnett I*, it is necessarily part of the same transaction or series of transactions at issue in the earlier case. To the extent that Harnett's securities claims depend on the alleged misrepresentations by Billman and McCuistion at

the time of the EMSI spin-off, the claims are precluded by the judgment in *Harnett I*. The only securities claims that survive *Harnett I*, therefore, are those contained in Claim 1 and in the state securities law claims that depend on misrepresentations in connection with the purchase of Harnett's EMSI and ERSI stock on the freeze out mergers, which took place several months after the judgment in *Harnett I*.

Claim 6 of the complaint in *Harnett I* set out a state law claim for fraud. That claim, however, is also based on Harnett's allegations that the defendants fraudulently obtained EPIC stock and misrepresented and later concealed the diversion of servicing business between EMSI and ERSI and EMI. These claims also arose out of the same transaction or series of transactions, the various mergers and spin-offs, that were the basis for Harnett's claims in *Harnett I*, and the district court should properly have dismissed these claims as res judicata.

Harnett's final claim in this case is that Billman and McCuistion breached their fiduciary duty to him, as a minority shareholder, by their treatment of ERSI and EMSI. This claim relies partially on the share misappropriation and misrepresentation questions we have held precluded under other theories of relief, but also includes alleged breaches in the interval between the *Harnett I* judgment in February 1984 and the freeze out mergers later that year. To the extent that this claim is limited to breaches and injuries during that interval, it survives *Harnett I*. Accordingly, we conclude that res judicata precludes the litigation of all of Harnett's claim except this portion of the fiduciary duty claim, and the portion of the securities claims particular to the freeze out mergers of ERSI and EMSI. The district court granted summary judgment against each of these claims on other grounds, however, and we now examine Harnett's claims that the district court erred in doing so.

III

The district court dismissed all of Harnett's securities law claims upon the conclusion that neither the acquisition of ERSI and EMSI stock in the spin-offs, nor the disposition of Harnett's

shares in the freeze outs, constituted a "purchase or sale of securities" permitting Harnett to make claims arising under federal or state securities laws. Having found that most of Harnett's securities claims are barred by res judicata, however, we conclude that when Harnett's securities claims are limited to the freeze out mergers, it is unnecessary to resolve the question whether the forced "sale" of stock in a freeze out merger is a "sale" giving rise to securities claims. This follows because it is apparent on the record that Harnett has neither alleged, nor could he prove, any injury arising out of fraud in connection with the freeze out mergers.

Harnett's remaining securities claims are his § 10 and Rule 10b-5 allegations in his first claim, and his state law claims that incorporate the allegations of the federal claim. Examination of Harnett's complaint reveals, however, that there is no allegation of injury from these remaining claims. Harnett asserts that the misstatements and omissions in connection with the freeze outs, which relate to Harnett's claims that Billman and McCuistion misappropriated EPIC shares and therefore received too great a proportion of EMSI and ERSI shares, constituted misstatements and fraudulent behavior actionable under the securities laws. Although such behavior can only form the basis for a cause of action in Harnett if it caused an injury, the complaint makes no allegation of injury flowing from the alleged fraud, and it is apparent to us that there could be none.

The actual injury allegedly suffered by Harnett as a result of the share misappropriation is a dilution of Harnett's interests in ERSI and EMSI. While it is true that Harnett was further injured if, after the freeze outs, the misappropriation caused him to receive a lesser amount for his share of the companies, that result is not caused by any deceptive statements in connection with the share misappropriation. Not only did Harnett already know of this dilution claim, so that any misrepresentations did not conceal from him what he perceived to be the true state of affairs, but the misrepresentations themselves cannot have caused the dilution, which occurred as a result of earlier behavior by the defendants.

Because Harnett's remaining securities claims do not contain an allegation of injury caused by securities law violations, and because it was not possible for Harnett to show such an injury, the securities claims were properly subject to dismissal by the district court.

IV

Finally, Harnett argues that the district court erred in dismissing his claim for breach of fiduciary duty. The rationale for the district court's decision was that the fiduciary duty claim asserted by Harnett was a derivative claim available only to shareholders, and that because Harnett was no longer a shareholder of EMSI or ERSI, a derivative claim was no longer available to him.

We conclude that the district court properly applied Delaware law [2] in finding that a former shareholder such as Harnett was without standing to assert a derivative claim for breach of fiduciary duty. Although Harnett asserts that he could make these claims as a sole shareholder, it is clear that under Delaware law such an action is to be made only derivatively, *see Cole v. Ford Motor Co.*, 566 F. Supp. 558, 568-69 (W.D. Pa. 1983) (applying Delaware law). Moreover, a derivative action is not among the remedies available to a minority shareholder faced with a short form merger. Such shareholders are limited to injunctive relief if the merger is unfair, and to appraisal rights if the merger is fair. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

The judgment of the district court is affirmed in part and reversed in part.

AFFIRMED IN PART;
REVERSED IN PART.

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[2] Prior to their acquisition in the freeze out mergers, and at the time that Harnett was a shareholder, ERSI and EMSI were both Delaware corporations.

COURT OF APPEALS ORDER DENYING PLAINTIFF'S PETITION FOR REHEARING
October 29, 1986

United States Court of Appeals

FOR THE FOURTH CIRCUIT

No. 85-2338
No. 85-2339

WILLIAM J. HARNETT,
Appellee,

versus

TOM J. BILLMAN, *et al,*
Appellants,

and

EPIC MORTGAGE, INC., etc., *et al,*
Defendants.

Appeals from the United States District Court for the Eastern District of Virginia, at Alexandria. Albert V. Bryan, Jr., District Judge.

Upon consideration of the appellee William J. Harnett's petition for rehearing,

IT IS ORDERED that the petition for rehearing is denied.

Entered at the direction of Judge Phillips with the concurrence of Judge Russell and Judge Chapman.

For the Court,

JOHN M. GREACEN

CLERK

OPINION OF DISTRICT COURT,
October 7, 1985

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA ALEXANDRIA DIVISION

CIVIL ACTION NO. 85-157-A

WILLIAM J. HARNETT,
Plaintiff,

v.

TOM J. BILLMAN, *et al.*,
Defendants.

MEMORANDUM OPINION

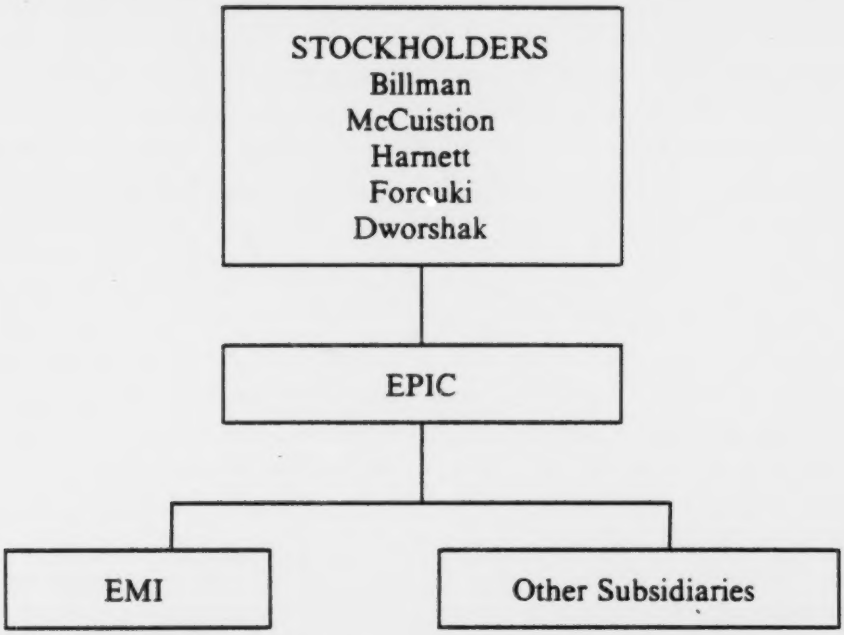
This common law fraud [1] action was tried to the court on September 16-17, 1985. Decision was reserved to permit the court to review portions of certain transcripts, and for the parties to file and the court to consider post trial briefs. This has now been accomplished.

The controversy arises out of the stockholdings of the plaintiff, William J. Harnett (Harnett), in Equity Programs Investment Corporation (EPIC). EPIC's principal business involves the purchase of model homes from builders who need the capitol which is tied up by their holding of models for lengthy periods of time. The model homes are then leased back to the builders. Limited partnerships formed for the purpose of holding title to the properties. Investors are sought as limited partners and EPIC is the general partner.

[1] The amended complaint contained counts of violations of the Securities Act of 1933 (Counts 2 and 3), the Securities Exchange Act of 1934 (Count 1), the Virginia Securities Act (Count 4), the Delaware Securities Act (Count 5), and common law fraud (Count 6). By the time of trial only Count 6 remained in the case.

Harnett was an original investor in EPIC, purchasing 1250 shares for $5,000 in 1975. The other investors and original stockholders included the defendants Tom J. Billman (Billman) and Clayton C. McCuistion (McCuistion). Minority stockholdings other than the plaintiff's were acquired by Billman and McCuistion over the years so that by the time the events at issue here occurred in February and March of 1983, Harnett was the only minority stockholder, and the shareholdings were as follows: Billman, 75,875; Billman, trustee, 1,250; McCuistion, 22,175; and Harnett, 1,250.

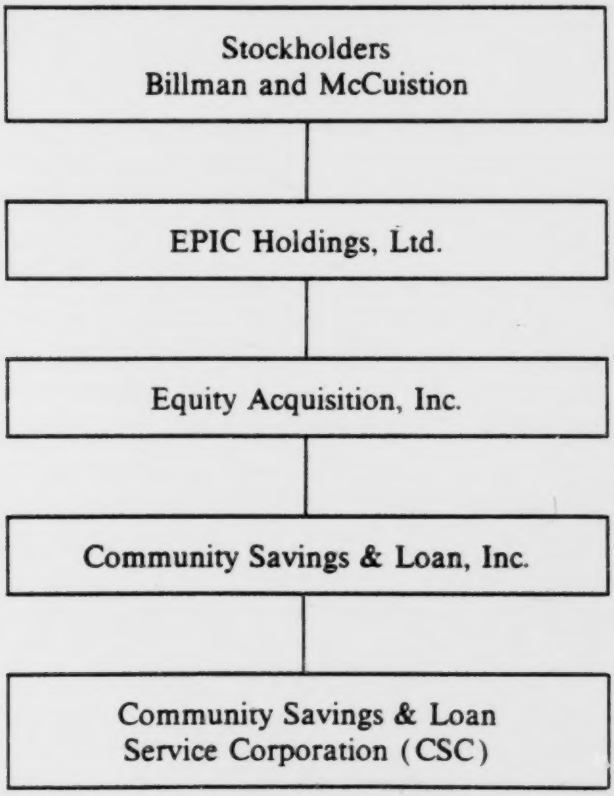
As late as June, 1982 the corporate structure of EPIC, and the subsidiary of EPIC that is involved here, EPIC Mortgage, Inc. (EMI), was as follows:



On June 18, 1982, EPIC Realty Services, Inc., was spun off from EPIC, in a tax free transfer to its shareholders. That corporation performed management and related realty service operations for properties owned or controlled by EPIC or its related corporation or by Billman and McCuistion. The spin-off of ERSI is only relevant to the issues in this case because Harnett asserts, as one of the fraudulent representations alleged

to have been made by the defendants, that he was told in 1983 that the proposed spin-off from EMI of EPIC Mortgage Servicing, Inc. (EMSI) would be just like the spin-off of ERSI. Harnett received his proportionate share of ERSI stock in the spin-off of that corporation from EPIC. It is around the spin-off of EMSI that this controversy centers.

Unbeknownst to Harnett, by October 1982, Billman and McCuistion had acquired, through various holding companies, controlling interest in another company, Community Savings and Loan, Inc. (Community Savings), and its subsidiary, Community Savings and Loan Service Corporation (CSC), the entity which was later to acquire EPIC by merger. The structure of this interest was as follows:



On January 27, 1983, Harnett received a formal notice from EPIC of its proposed merger into CSC. The notice revealed that Billman and McCuistion controlled Community

Savings. The proposal in the notice was that, in exchange for his shares in EPIC, Harnett was to receive preferred stock in Community Savings. Notice was also given of a February 23, 1983 shareholders meeting to vote on the merger. The notice recommended that Harnett consider selling his shares in EPIC to Billman and McCuistion. Harnett was unhappy with the proposal to receive only fixed value, non-convertible, non-voting preferred stock in a company, Community Savings, whose common stock was controlled by Billman and McCuistion. The notice of merger did not mention any spin-off from EMI of EMSI. Harnett called Billman, who indicated that he was not surprised at Harnett's dissatisfaction, and that he, Billman, would pay Harnett a premium for his stock. In this or a subsequent conversation prior to February 23, 1983, Billman told Harnett that he was thinking of spinning off "the mortgage company." Later, on the day prior to the February 23 stockholders meeting, Billman told Harnett that all of the operations related to mortgage servicing [2] were going to be spun off into a new company which would do all the servicing of mortgages for the combined EPIC/Community Savings operation. Also on February 22, Billman and McCuistion indicated to Harnett that they would pay up to $100,000 for his stock in EPIC. Harnett asked for more information, more disclosure, and asked Billman why nothing was said in the merger notice about the spin-off. Billman said that he would let him know the answer to this the next day before the shareholders' meeting. Harnett at that time indicated that he probably would dissent from the merger. The next day, just prior to the proposed shareholders' meeting, Harnett again complained of a lack of disclosure and of receiving worthless stock in exchange for his EPIC shares. He was again told that all matters related to mortgage servicing for EPIC and Community Savings portfolios were being transferred to a new and separate company. Harnett was told that

[2] Mortgage servicing means collecting mortgage payments from the mortgagor, and disbursing those payments to the mortgagee as well as setting up escrow accounts from which timely payments of taxes and insurance premiums would be paid. In the case of the EPIC "product" this included collecting and paying homeowners' association dues, which would otherwise constitute a lien prior to the mortgagee's lien, and various accounting and reporting procedures necessitated by the limited partnership interests.

the spin-off would be just like ERSI. Harnett knew that EMI, the company from which the new company, EMSI, would be spun off, would continue to originate loans, but was led to believe that EMI would not continue to service loans—that was to be done by EMSI.

Harnett's complaints about what he was to receive from the merger prompted Billman and McCuistion to offer him an option to purchase his pro rata share in Community Savings at a price per share. This was agreeable to Harnett, and the necessary documents were to be drawn up and sent to Harnett. According to Harnett the stockholders' meeting was cancelled, and he left to await the documents. When the documents arrived (PX 28), he called EPIC's counsel, Deerin, to ask for more information and to indicate that he would not exercise the option until he had more information.

A meeting was set up for March 3, 1983. At its beginning Billman handed Harnett a retraction of the option (PX 48). There was some discussion of the spin-off at this meeting. Unbeknownst to Harnett, the spin-off had already occurred on March 2. He received his certificate for 1250 shares in EMSI, dated March 2, 1983, sometime after March 16, 1983 (PX 58).

Billman's and McCuistion's version of the happenings at the meetings of February 22, 23 and March 3, differs from that of Harnett. They say the discussion of the spin-off occupied a minor part of only the meetings of February 22 and 23; that it was not discussed at all on March 3; and that the discussion consisted only of a statement that the spin-off would be like the one for ERSI, to which Harnett responded "fine." They further state that the shareholders' meeting was not cancelled, but went ahead, and the merger was approved [3] despite objection from Harnett as to lack of disclosure and "10-b-5" violations; and most specifically they deny that Harnett was ever told that all operations related to mortgage servicing of EPIC and Community Savings loans would be transferred to EMSI.

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[3] The appraisal of the value of Harnett's EPIC stock as a result of his dissent is pending in an appropriate proceeding in the Circuit Court of Fairfax County, Virginia.

The court accepts Harnett's version of the meetings for the most part. But the court finds, in any event, that Billman and Harnett wanted to spin off the valuable rights to service the mortgages of EPIC and Community Savings from EMI before the merger took place, perhaps so they would not be encumbered by the spun off company having to deal with the Maryland regulatory authorities. If the spin-off occurred while Harnett was a stockholder of EPIC, then he would have to receive a proportionate share in the new EMSI. This they did not want, and it was for this reason that they did not tell him originally of the proposed spin-off when notifying him of the merger. When he asked for more disclosure, wisdom dictated that he had to be told of the spin-off. But they first tried to buy his stock. They made the proposed exchange to unattractive for him that perhaps he would sell rather than accept it. When he wouldn't sell his stock, they spun off EMSI before the merger but immediately took away from it the substantial earning capacity it would have had if it had been given the capabilities that had been represented as planned for it.

Indeed, it appears that such a plan existed. Minutes of a February 25, 1983 board of directors of EMI meeting state, in part:

> . . . the principal business of [EMI] is the origination, sale and servicing of commercial and residential mortgage financing.
>
> . . . the activities of servicing the loans . . . have heretofore been conducted by the Corporation.
>
> . . . there exists an opportunity for expansion of the mortgage servicing activity by enlarging same to include all those services customarily offered by other mortgage servicing organizations and to offer such services to other unrelated corporations or lending institutions.
>
> * * * *
>
> it is deemed desirable to place under the control of a separate corporate body the property of the Corpo-

> ration devoted to the business of mortgage servicing and its related operations, including, without limitation, such escrow balances as are incidental thereto. . . .
>
> * * * *
>
> that following the creation of EMS and the adoption of the plan set forth herein by the sole shareholder hereof, this Corporation shall transfer and convey to EMS all of the operations, including existing escrow account balances, of the Corporation related to mortgage servicing as of the date of such transfer. . . .

(PX 31)

Minutes of an EPIC board of directors meeting of March 1, 1983, state, in part:

> . . . EMS will engage in the activities of servicing commercial and residential mortgage loans originated and sold by EMI . . . .
>
> * * * *
>
> there exists an opportunity for expansion of the mortgage servicing activity by enlarging same to include all those services customarily offered by other mortgage servicing organizations and to offer such services to other unrelated corporations or lending institutions independently of the principal business of the Corporation. . . .
>
> * * * *
>
> it is deemed desirable to place under the control of the shareholders of the Corporation the property of the EMS devoted to the business of mortgage servicing and its related operations. . . .

(PX 41)

Despite the foregoing, on March 1, 1983, a subservicing agreement (PX 69) between EMI and EMSI was executed whereby the latter employed EMI to do all the servicing of the mortgages on a fee basis, producing some revenue for EMSI

which was nearly all paid out in salaries to Billman and McCuistion. While some limited new mortgage servicing was transferred to EMSI immediately after the spin-off, nothing else of substance was ever transferred by EMI to EMSI. It never had any employees except Billman and McCuistion, president and vice president, respectively, Ms. McKinney, who later became a vice president, and perhaps one other individual. EMSI never actually serviced a mortgage. None of the employees was full time. There was no transfer of employees to EMSI. It had no listed telephone, office, stationery or tangible assets. EMSI's only asset was the *right* to service mortgages, a right it transferred to EMI before exercising it. The spin-off in all probability was not a tax free one.

Harnett knew none of the foregoing until November, 1984. He received a letter from Ms. McKinney (PX 184) advising him that as of November 28, 1984,[4] the date of the letter, EMSI had merged into Cavalier Oil Corporation (Cavalier), which had apparently acquired nearly all of the holdings of Billman and McCuistion in EMSI. The letter enclosed a check for $93,950 for Harnett's stock.[5] Until November 1984, Harnett assumed that EMSI was servicing the mortgages for EPIC/Community as he had been told would be done.

The court finds from the foregoing, by clear and convincing evidence, that both Billman and McCuistion made false

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[4] It is this late notification to Harnett, as a result of which he learned that EMI, not EMSI, was reaping the benefits of the spin-off, and that EMSI had since March, 1983, been only a paper company, that defeats the *res judicata*-based motion to dismiss of the defendants. That motion relies on a February 4, 1984 dismissal with prejudice of prior fraud action brought by the plaintiff in this court. The complaint in that action alleged fraud by Billman and McCuistion and others in connection with the merger between EPIC and CSC. Although the spin-off of EMSI is mentioned in the amended complaint in that action [¶ 49(h)], that action did not embrace the allegations of material misrepresentations regarding the spin-off, which are involved here and which were not known to be misrepresentations at the time of the February 4, 1984 dismissal of the fraud claims in the prior action.

[5] The merger of Cavalier and EMSI was a so-called "short form" merger under Delaware law. Under it a stockholder such as Harnett who is "frozen out" can ask for an appraisal of his stock if he disagrees with what has been offered him. This remedy is being pursued by Harnett in Delaware.

representations to Harnett concerning their intentions with regard to what EMSI's future activity would be after the spin-off. The March 1, 1983 subservicing agreement was obviously not conceived of on March 1. Moreover, even if the original intention had been for a tax free spin-off of the mortgage servicing functions of EMI and for EMSI to service thereafter the mortgages of the combined EPIC/Community operation, their failure to disclose this change of intention and their divesting EMSI of all of its income producing capabilities constituted a misrepresentation. Given what they had told Harnett in the past, they owed him a disclosure of what actually was being done in order for the past statements not to be misleading. They had a continuing duty to so disclose as long as the facts were material and remained undisclosed, which was the case here. Moreover, they had a duty to correct previous misrepresentations or misleading statements of material facts since the facts which had not been disclosed continued to be material. It is clear to the court that the failure to so advise Harnett was in order to lull him into inaction, and it did. The justifications proferred by Billman and McCuistion for their change of mind are not convincing, but even if there were arguable reasons for their actions, at the very least they owed it to Harnett to tell him of what action was being taken.

The plaintiff asserts that his reliance on the misrepresentations resulted in the following:

1. He did not sell his EPIC stock to Billman and McCuistion because he wanted to obtain the benefits of his interest in the spun off corporation, EMSI.

2. He did not file a derivative suit as an EMSI shareholder to recover sums unlawfully diverted from EMSI by Billman and McCuistion. Since he is no longer a shareholder in EMSI this remedy is not available to him now.

3. He did not exercise his option to purchase Community Savings stock during the period before the option was retracted by Billman on March 3, 1983.

4. He did not report his receipt of EMSI stock as a potentially taxable transaction.

5. He maintained ownership of his EMSI stock and made no effort to sell it.

6. He dismissed his prior fraud action in favor of a stock appraisal proceeding.

The court is convinced that all of the foregoing assertions are true. However, finding with any reasonable certainty and without speculation that any one or more of them can be quantified in terms of damages is not possible. But the court finds, by clear and convincing evidence, that misrepresentations have been made to the plaintiff and that the plaintiff has reasonably relied upon them. Under these circumstances the court ought not to deny the plaintiff damages because they cannot be established with precision.

It seems to the court that the proper measure of damages to which the plaintiff is entitled is that amount he would have received as a result of his stock holdings in EMSI if EMSI had done the mortgage servicing which Billman and McCuistion represented it would do but which instead was done by EMI. And this should be calculated by using what EMI actually earned. Recent events, mainly the demise of the EPIC/Community group of companies, establishes that in all probability there will be no future loans from EPIC and Community Savings for EMI to service. It will, presumably, continue to service the existing portfolio. Harnett objects to any consideration of these recent events. However, they undoubtedly would have occurred even if EMSI had received in the spin-off all that had been represented.

Accepting the calculations of the plaintiff as to the income of EMI, which properly belonged to EMSI, during the period March 3, 1983 until October 31, 1984, a 20 month period (PX 205A) at $1,441,313; and assuming, as did the plaintiff's expert, an 80% dividend pay out for this type of service company, plaintiff's income over those 20 months would be $14,344. This

equates to $717 per month, or $8,604 annually. This results in a damage figure as follows:

Lost earnings for the period March 1, 1983 to October 31, 1984	$14,344.00
Lost earnings for the period October 31, 1984 to September 30, 1985	9,321.00
Total Damages	$23,665.00

The court has thus rejected the plaintiff's method of computing damages, which he measures by the value his stock in EMSI would have had if EMSI had been doing all of the business originally represented as projected for it. The value is determined by capitalizing projected earnings, assuming in this projection an increase each year. Plaintiff then arrives at his damage total by deducting from the value so computed the $93,950 offered him in the merger of EMSI and Cavalier. The court does not feel that this is the proper measure of damages. It gives the plaintiff more than he has lost as a result of the particular fraudulent misrepresentation of which he complains. Moreover, it duplicates, even with the $93,950 deduction, the remedy afforded by the pending appraisal proceedings. Projecting damages beyond November 28, 1984 also gives the plaintiff more than he lost, since after that date he no longer was an EMSI stockholder. It is only speculation that had EMSI performed the mortgage servicing as represented, the merger between Cavalier and EMSI would not have taken place.

As to the defendants EMI, Cavalier and ERSI, there has been shown no activity *on their behalf* which amounts to fraud. Billman and McCuistion were acting for their own individual benefit. Indeed, they may have acted contrary to the best interests of the corporate defendants, particularly EMI. Consequently, the judgment to be awarded will be against Billman and McCuistion only, and the action will be dismissed as to the corporate defendants.

The court has found the individual defendants guilty of making fraudulent representations, and the representations are sufficiently egregious to constitute a willful and wanton disregard of the plaintiff's rights. Billman is, from the record in the case, the more culpable of the two. Accordingly, punitive damages will be awarded against Billman in the amount of $25,000 and McCuistion in the amount of $10,000.

United States District Judge

Alexandria, Virginia
October 7th, 1985

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA ALEXANDRIA DIVISION

CIVIL ACTION NO. 85-157-A

WILLIAM J. HARNETT,
Plaintiff,

v.

TOM J. BILLMAN, *et al.*,
Defendants.

ORDER

For the reasons set forth in the Memorandum Opinion this day filed, it is ORDERED that:

1. Judgment is entered on Count 6 of the Amended Complaint in favor of the plaintiff William J. Harnett as follows:

a. Against the defendants Tom J. Billman and Clayton C. McCuistion, jointly and severally, in the amount of $23,665.00 in compensatory damages, plus costs; and

b. Against the defendant Tom J. Billman in the amount of $25,000.00 in punitive damages; and

c. Against the defendant Clayton C. McCuistion in the amount of $10,000.00 in punitive damages.

2. Judgment is entered in favor of the defendants Epic Mortgage, Inc., Cavalier Oil Corporation and Epic Realty Services, Inc., against the plaintiff William J. Harnett on Count 6 of the Amended Complaint.

United States District Judge

Alexandria, Virginia
October 7th, 1985

DISTRICT COURT ORDER of November 1, 1985

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA ALEXANDRIA DIVISION

CIVIL ACTION NO. 85-157-A

WILLIAM J. HARNETT,
Plaintiff,

v.

TOM J. BILLMAN, *et al.*,
Defendants.

ORDER

For the reasons stated from the bench, it is hereby ORDERED that the judgment of October 7, 1985 is amended so that the compensatory damages awarded are in the amount of $69,132.00 instead of $23,665.00, the court accepting the computations set forth in Paragraphs 1, 2 and 3 of the plaintiff's memorandum in support of his motion to amend judgment, finding them supported by the existing evidence in the case.

In all other respects the judgment of October 7, 1985 shall remain the same.

United States District Judge

Alexandria, Virginia
November 1st, 1985

DISTRICT COURT ORDER of March 22, 1985

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA ALEXANDRIA DIVISION

CIVIL ACTION NO. 85-157-A

WILLIAM J. HARNETT,
Plaintiff,

v.

TOM J. BILLMAN, *et al.*,
Defendants.

ORDER

Upon consideration of the motion of the defendants for summary judgment on all counts, it is, for the reasons stated from the bench, ORDERED that:

1. The defendants' plea of *res judicata* is sustained only to the extent that the plaintiff may not litigate in this action claims that:

a. On June 24, 1981, EPIC acquired an option to purchase 29,000 shares of EPIC common stock from William J. Moore and Mary B. Moore at a price of $400,000, or approximately $13.79 per share.

b. In June, 1982 defendants Billman, McCuistion and Deerin, individually and as officers and directors of EPIC, wrongfully and fraudulently caused EPIC to either assign its option to purchase the Moores' 29,000 shares to defendants Billman and McCuistion, or assign the 29,000 shares themselves to defendants Billman and McCuistion. In either case, the assignment was made in exchange for inadequate consideration.

c. This assignment of shares and/or option to Billman and McCuistion diluted the value of Harnett's interest in EPIC both with respect to the purported merger of EPIC into CS&L Service Co., as well as with respect to EPIC's spin-off of EPIC Realty Services, Inc., and EPIC Mortgage Servicing, Inc.; or any alleged improprieties directly arising from the above claims.

1. Counts 1, 2, 3, 4 and 5 are dismissed because the court finds that the alleged misconduct was not in connection with the sale or purchase of a security.

_____

United States District Judge

Alexandria, Virginia
March 22nd, 1985

DISTRICT COURT ORDER of July 16, 1985

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA
Alexandria Division

Civil Action No. 85-00157-A

WILLIAM J. HARNETT,

Plaintiff,

v.

TOM J. BILLMAN, *et al.*,

Defendants.

ORDER

This matter comes before the Court on defendants' motion for summary judgment on Counts 6 and 7 of plaintiff's complaint and on defendants' motion to strike claims barred by the Court's March 22, 1985 order.

The Court GRANTS IN PART and DENIES IN PART defendants' motion for summary judgment. The Court GRANTS defendants' motion as to Count 7 of the complaint. Plaintiff's claim for breach of fiduciary duties is derivative in nature. Therefore, plaintiff cannot assert Count 7 in his individual capacity. Plaintiff has neither alleged a special injury nor can he claim that the alleged wrong affected a right that he particularly held. Plaintiff admits that he cannot maintain an stockholder derivative suit. Therefore, Count 7 of his complaint must be dismissed. *See Bennett v. Breuil Petroleum Corp.*, 99 A.2d 236 (1953); *Elster v. American Airlines*, 100 A.2d 219 (1953).

The Court DENIES defendants' motion for summary judgment as to Count 6. Plaintiff has raised issues of material

fact regarding defendants' fraudulent misrepresentation and his reliance thereon. The fact that plaintiff could not have prevented the EMSI spin-off by vote does not foreclose his opportunity to assert that he relied upon the alleged misrepresentation when determining how to proceed with his options. Furthermore, an issue for trial is whether the ERSI spin-off was conducted in good faith and whether it was a reasonable transaction in light of the fiduciary duties the individual defendants owed to various corporations. Finally, the alleged misrepresentation does not have to be in writing in order for plaintiff to claim he relied upon it to his detriment. Plaintiff does not assert that he and the individual defendants entered into a contract. Therefore, Delaware's Statue of Frauds does not apply.

The Court GRANTS defendants' motion to strike claims barred by order dated March 22, 1985. In the previous order, the Court held that *res judicata* barred plaintiff from litigating, in the present action, any claims that directly arise from the individual defendants' acquisition, assignment or exercise of an option to purchase 29,000 shares of EPIC common stock from William J. Moore and Mary B. Moore. The fact that Mr. Ward Dworshak held the 29,000 shares at the time of the ERSI spin-off and Community Savings and Loan Service Corporation held the stock at the time of the EMSI spin-off does not alter this ruling. Plaintiff cannot rely on any facts involving the option to purchase the Moores' stock when proving his present allegation of common law fraud.

Let the Clerk send a copy of this order to all counsel of record.

DATE: _____

_____

UNITED STATES
DISTRICT COURT

DISTRICT COURT ORDER IN *HARNETT* v. *BILLMAN*, No. 83-1029-A, February 16, 1984

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA ALEXANDRIA DIVISION

CIVIL ACTION NO. 83-1029-A

WILLIAM J. HARNETT,
Plaintiff,

v.

TOM J. BILLMAN, *et al.*,
Defendants.

ORDER

In appearing that the parties have agreed to settle this case by defendants' allowing the plaintiff to exercise his appraisal rights, it is hereby ORDERED that:

1. Count I of the Amended Complaint is dismissed with prejudice.

2. Count V of the Amended Complaint is dismissed without prejudice only insofar as the dismissal is not deemed to prejudice the plaintiff's right to assert the facts underlying the derivative action of Count V as those facts may affect the value of the plaintiff's stock.

3. Discovery conducted in this action shall be available for use in the appraisal proceedings.

And nothing further remaining to be done in this action, it is hereby dismissed.

United States District Judge

Alexandria, Virginia
February 16th, 1984

Supreme Court, U.S.
FILED
MAR 2 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1221

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

WILLIAM J. HARNETT,
Petitioner,

v.

TOM J. BILLMAN,
CLAYTON C. McCUISTION,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF FOR TOM J. BILLMAN AND CLAYTON C. McCUISTION IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the federal law of *res judicata* should be applied to determine the scope and effect of a prior federal court judgment in a case where the exclusive jurisdiction of the district court was invoked to adjudicate alleged violations of the federal securities laws and the Racketeer Influenced and Corrupt Organizations Act and where the district court's pendent jurisdiction was also invoked over state tort claims, all arising out of the same common nucleus of operative facts.

2. Whether this Court should accept certiorari in a case where the Fourth Circuit recognized a "fraudulent concealment" exception to the doctrine of res judicata but determined, after reviewing the record, that such exception did not apply to this case.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

No. 86-1221

WILLIAM J. HARNETT,
Petitioner,

v.

TOM J. BILLMAN,
CLAYTON C. McCUISTION,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

---

BRIEF FOR TOM J. BILLMAN AND CLAYTON C. McCUISTION IN OPPOSITION

STATEMENT OF THE CASE

In his Petition, plaintiff William J. Harnett ("Harnett") makes numerous factual misstatements and omits many relevant facts. Plaintiff omits the fact that in *Harnett, I*,[1] he invoked the exclusive jurisdiction of the federal court to seek damages for alleged violations of

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[1] *"Harnett I"* refers to *Harnett v. Billman, et al.*, No. 83-1029-A (E.D. Va. 1983), the first case filed by plaintiff in October 1983.

the federal securities laws' anti-fraud provisions and RICO.[2] (Pet. App. A4-A5.)[3] Similarly, plaintiff omits the fact that in *Harnett II*, he again invoked the exclusive jurisdiction of the federal court to adjudicate his claim of damages for alleged violations of the federal securities laws' anti-fraud provisions.[4] The federal and state law claims in both cases were based on the same common nucleus of operative facts. (Pet. App. at A3-A5, A11.) Plaintiff could not have maintained either *Harnett I* or *Harnett II* in the state courts.

THE FACTS

By January 1983, respondents Tom J. Billman and Clayton C. McCuistion owned more than 90% of the stock of Equity Programs Investment Corporation ("EPIC") and also owned a majority of the stock of Community Savings & Loan ("CSL"). (Pet. App. at A3.) Petitioner William J. Harnett owned 1,250 shares of EPIC stock. (Pet. App. at A3.)

EPIC was the parent corporation of EPIC Mortgage, Inc. ("EMI"), a company engaged principally in mort-

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[2] In *Harnett I*, plaintiff sought damages for alleged violations of Section 10b of the Securities and Exchange Act of 1934 (15 U.S.C. § 78(j)), of Rule 10b-5 (17 C.F.R. § 240.10b-5) and of the Racketeer Influenced and Corrupt Organizations Act (18 U.S.C. § 1964; "RICO"). Exclusive federal jurisdiction was invoked under Section 27 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78aa and under 18 U.S.C. § 1964.

[3] Citation to the Appendix to the Petition are referenced as "Pet. App."

[4] In *Harnett II*, plaintiff sought damages for alleged violations of Section 10b of the Securities and Exchange Act of 1934 and Rule 10b-5 and Sections 12(2) and 17(a), Securities Act of 1933 (15 U.S.C. §§ 77(b) and 77(g) (1982)). Exclusive jurisdiction was invoked under Section 27 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78aa and Sections 1331 and 1337 of the Judicial Code, 28 U.S.C. §§ 1331, 1337.

gage origination and mortgage servicing. (Pet. App. at A3-A4.) On March 14, 1983, EPIC and its wholly-owned subsidiary, EMI, were merged into a wholly-owned service corporation of CSL. (Pet. App. at A4.)

Prior to the CSL/EPIC merger, the then existing mortgage servicing portfolio of EMI was spun off to a new company, EPIC Mortgage Servicing, Inc. ("EMSI"). (Pet. App. at A3-A4.) Harnett received 1250 shares of EMSI stock as a result of his ownership of EPIC stock. (Pet. App. at A4.)

EMI and EMSI entered into a subservicing agreement, dated March 1, 1983, under which EMI performed for a fee the servicing work for the mortgages in EMSI's portfolio. (Pet. App. at A4.) After the EPIC/CSL merger, EMI also became the servicer of new mortgages originated by the new EPIC/CSL entity. (Pet. App. at A4.) EMSI did not receive any of the new mortgage servicing business generated by the EPIC/CSL group but retained only the servicing rights in the portfolio originally spun off to it from EMI. (Pet. App. at A5.)

In October 1983, plaintiff initiated *Harnett I* in the United States District Court for the Eastern District of Virginia. There, plaintiff's federal and state claims were both based on allegations that Billman and McCuistion made fraudulent misrepresentations or omissions to Harnett in certain communications in late February and early March 1983 relating to the EPIC/CSL merger and the EMSI spin-off. (Pet. App. at A5.) Based on these allegations, plaintiff sought damages for alleged violations of the federal securities laws and RICO and for common law fraud and breach of fiduciary duty with respect to EMSI. (Pet. App. at A4-A5.)

Harnett sought and received extensive discovery throughout the *Harnett I* litigation of the business rec-

ords of EMI and EMSI as well as other companies related to EPIC and CSL. (Pet. App. at A5, A9.) In this discovery, Harnett received information enabling him to conclude that EMI was servicing mortgages and that EMSI's servicing portfolio had not expanded beyond that which it held at the time of its spin-off from EMI in early 1983. (*Id.*) Harnett also obtained a copy of the EPIC/CSL consolidated annual report, dated March 31, 1983, which disclosed the spin-off of EMSI, stated that EMSI received in the spin-off the "existing mortgage servicing operations of EPIC," and indicated that EPIC planned to enter into sub-servicing agreements with EMSI. (Pet. App. at A9.)

In February 1984, after all discovery had been completed, *Harnett I* was dismissed with prejudice. (Pet. App. at A5.) In February 1985, Harnett instituted the present action, referred to as *Harnett II*, against Billman and McCuistion in the United States District Court for the Eastern District of Virginia. (Pet. App. at A5.)

In *Harnett II*, plaintiff again asserted claims under the federal and state securities acts, for common law fraud and for breaches of fiduciary duty. (Pet. App. at A5.) The *Harnett II* complaint alleged that in the same communications at issue in *Harnett I*, Billman and McCuistion had misrepresented to Harnett that the new, spun off EMSI company would receive not only EMI's existing mortgage servicing business as of the date of the spin off but all of the future servicing business generated by the merged EPIC/CSL group, and that respondents failed to tell Harnett about the EMI/EMSI sub-servicing agreement, and, that EMI, not EMSI, was receiving the servicing business on new mortgages originated by the EPIC/CSL group. (Pet. App. at A5).

The Fourth Circuit held that the district court improperly failed to enter judgment for Billman and McCuistion on grounds of *res judicata*. (Pet. App. at A7.)

SUMMARY OF ARGUMENT

The writ should be denied for the following reasons:

1. This case does not present the issue of whether federal or state law of *res judicata* should be applied to determine the scope and effect of a prior federal court judgment in a diversity case to bar claims alleged in a subsequent diversity case. In *Harnett I*, plaintiff sought damages for alleged violations of rights afforded him by the federal securities laws and RICO as well as for state common law torts. Similarly, in *Harnett II*, he sought damages for alleged violations of the federal securities laws as well as for state common law torts. All the claims in *Harnett I* and *Harnett II* were based on the same common nucleus of operative facts. (Pet. App. at A3-A5, A11.) Plaintiff could not have litigated his claims in either *Harnett I* or *Harnett II* in the state courts. Plaintiff invoked the exclusive jurisdiction of the federal court in *Harnett I* and *Harnett II* to adjudicate his federal claims as well as other pendent claims.

The district court in *Harnett I* adjudicated the merits of his claims, and the rulings of the district court were merged in one final judgment. Now, for the first time in his Petition, Harnett argues that the scope and effect of this federal court judgment should be determined by applying state law.

Harnett's argument ignores the fact that even if he had only pled his federal claims in *Harnett I*, his state claims arising from the same common nucleus of operative facts would have been barred by the judgment in *Harnett I* under the federal law of *res judicata*. There is no conflict among the circuits on this point. Courts and commentators uniformly recognize that the issue of the scope and effect of a federal court judgment must be decided by federal law. Any other result would erode the finality of federal court judgments. Determinations of the scope and effect of a judgment define the finality

of the judgment. Finality is an essential element of a court's authority and is a fundamental principle of judicial integrity and consistency.

2. The Fourth Circuit recognized the existence of a fraudulent concealment exception to the federal law of *res judicata* but determined after reviewing the record that such exception did not apply in this case. Harnett only disputes the Fourth Circuit's application of the exception based on the specific facts of record, hardly an issue worthy of review by this Court.

ARGUMENT

I. The Petition Should Be Denied Because The Scope And Effect Of A Federal Court Judgment Are Determined By Federal Law

In *Harnett I*, plaintiff invoked the exclusive jurisdiction of the district court to adjudicate his claim for federal securities fraud and RICO violations as well as for state common law torts. (Pet. App. at A4-A5; and *supra* at 2 n.2.) Harnett's federal claims in *Harnett I* were adjudicated on the merits and the rulings on all his claims were merged into one, final federal court judgment on all his claims.

Harnett II was likewise not a diversity case. In *Harnett II*, plaintiff alleged claims for alleged violations of the federal securities laws and invoked the exclusive jurisdiction of the federal district court to adjudicate these claims. *Supra* at 2, n.4.

The Petition inaccurately asserts that *Harnett I* and *Harnett II* were strictly diversity cases, and, therefore, *Erie* requires that state law of *res judicata* govern the determination of the scope and effect of the federal judgment in *Harnett I*. Because *Harnett I* and *Harnett II* involved federal and state claims arising from the same common nucleus of operative facts, petitioner's arguments based on diversity jurisdiction are irrelevant. The

district court had pendent jurisdiction over Harnett's state common law claims, and those claims would have been barred by the judgment in *Harnett I*, even if not pled. *Federated Department Stores, Inc. v. Moitie*, 452 U.S. 394 (1981) (Blackmun, J., concurring). The fact that such claims were pled could not narrow or affect the scope of the federal judgment in a case where the district court had exclusive jurisdiction over federally created claims arising from the same common nucleus of operative facts as the state claims.

A contrary result would promote claim splitting, cause uncertainty as to the finality of federal judgments and lead to the uneven administration of justice. For example, as petitioner has attempted to do here, federal securities law fraud claims would be split from state common law fraud claims and litigated separately in successive lawsuits in the hopes of having "two bites of the apple." This Court has continually expressed a strong policy of protecting the "conclusive character" of federal judgments and of requiring plaintiffs to litigate all their claims at one time. *Federated Department Stores, Inc. v. Moitie*, 452 U.S. at 398-399 and 401; *United States v. California & O. Land Co.*, 192 U.S. 355, 358 (1903).

The scope and effect of a judgment "define[s] finality and hence go[es] to the essence of the judicial function." *Restatement (Second) of Judgments*, § 87, Comment b, at p. 317 (1982). The Court has long recognized that the policy of finality as expressed in the doctrine of *res judicata* "is a rule of fundamental and substantial justice." *Federated Department Stores, supra*, at p. 401. Courts have uniformly held that federal law of *res judicata* should be applied to determine the scope and effect of federal judgments in cases involving federally created claims within the exclusive jurisdiction of the federal courts. *Federated Department Stores, Inc. v. Moitie, supra; Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940).

Courts and commentators have also uniformly stated that the scope and effect of a federal judgment must be determined by the federal law of *res judicata*, whether in a federal claim case or a diversity case. As stated in the *Restatement (Second) of Judgments:*

> The principle of finality is an essential element of a court's authority. The rules of res judicata express the quality of a court's authority, not only in general doctrine but in the technical particulars of the rules. The source of the federal courts' authority is in Articles I and III of the constitution. It is therefore appropriate to hold that, at least in the absence of some other provision by Congress, the effects of a federal judgment are a legal implication of those provisions. That proposition is expressed in modern decisions.

Restatement (Second) of Judgments, § 87 Comment a at p. 315 (1982) and § 87, Comment a, illustrations 1 and 2; 1B *Moore's Federal Practice*, § 0.406[1] at p. 272 (1984); *Southwest Airlines Co. v. Texas Intern. Airlines*, 546 F.2d 84, 94 (5th Cir. 1977).

Petitioner has not cited any precedent conflicting with the Fourth Circuit's opinion that the federal law of *res judicata* should be applied to determine the scope and effect of a federal judgment in a case involving federally created claims committed to the exclusive jurisdiction of the federal courts. Instead, petitioner attempts to misstate *Harnett I* as a diversity case.

Even if this case were inaccurately characterized as a diversity case, there is no split among the circuits.

Contrary to petitioner's arguments, every court of appeals which has considered the issue has held that the federal law of *res judicata* is applicable to determine the scope and effect of a prior federal judgment even in a diversity case. In addition to the Fourth Circuit, the Second, Fifth, Sixth, Eleventh, and District of Columbia Circuits have held that the federal law of *res judicata*

should be applied to determine the preclusive effect of a prior federal judgment in a diversity case. *Kern v. Hettinger*, 303 F.2d 333 (2d Cir. 1962); *AEROJET-General Corporation v. Askew*, 511 F.2d 710 (5th Cir.), *cert. denied*, 423 U.S. 908 (1975); *Cemer v. Marathon Oil Co.*, 583 F.2d 830 (6th Cir. 1978); *Silcox v. United Trucking Service, Inc.*, 687 F.2d 848 (6th Cir. 1982); *Precision Air Parts, Inc. v. Avco Corp.*, 736 F.2d 1499 (11th Cir.), *cert. denied*, 469 U.S. 1191 (1985); *Hunt v. Liberty Lobby, Inc.*, 707 F.2d 1493 (D.C. Cir. 1983). The holdings of these Circuit Courts of Appeals are in accord with Section 87 of the *Restatement (Second) of Judgments* that: "Federal law determines the effects under the rules of *res judicata* of a judgment of a federal court."

None of the cases cited in the Petition conflict with the Fourth Circuit's decision in this case. None of the cases cited by petitioner involve cases such as the present case where plaintiff has invoked the federal court's exclusive jurisdiction to adjudicate a federally created claim. Moreover, the cases cited by petitioner do not involve the issue of the scope and effect of a prior federal judgment. In *Hayles v. Randall Motor Company*, 455 F.2d 169 (10th Cir. 1971) and *Markariw v. Rinard*, 336 F.2d 333 (3d Cir. 1964), the courts stated, as the Fourth Circuit indicated here (Pet. App. at A8), that state law should be used to determine an issue of privity. Likewise, *Answering Services, Inc. v. Egan*, 728 F.2d 1500, 1506 (D.C. Cir. 1984),[5] and *Semler v. Psychiatric Institute of Washington, D.C.*, 575 F.2d 922, 925 (D.C. Cir. 1978), did not involve the scope of a prior federal judgment but turned on a determination of the underlying substantive elements of the substantive claim alleged in the subsequent suit. And, in *Gasbarra v. Park-Ohio Industries*,

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[5] The concurring opinion of then Circuit Judge A. Scalia accurately indicated that the decision turned on when the claim became actionable under state law, not on choice of law under *Erie*.

Inc., 655 F.2d 1119 (7th Cir. 1981), the court relied on federal law and *Moore's Federal Practice* to apply the *Restatement (Second)* analysis used by the Fourth Circuit here. Applicable state law was the same as federal law.[6]

II. The Petition Should Be Denied Because The Fourth Circuit Recognized The Existence Of A Fraudulent Concealment Exception But Based On The Record Facts, Determined That It Was Inapplicable In This Case

Contrary to the Petition, the district court stated that petitioner did not have actual knowledge of the claim before the dismissal of *Harnett I*. (Pet. App. at A23.) The Fourth Circuit did not "overlook" this statement but specifically referenced it and held that actual knowledge of a claim is not a precondition to the application of the rules of merger and bar. (Pet. App. at A8-A9.)

The Fourth Circuit recognized "an exception to the general principle that lack of knowledge will not avoid the application of the *res judicata* rules is found in cases where fraud, concealment, or misrepresentation have caused the plaintiff to fail to include a claim in a former action." (Pet. App. at A9.) After reviewing the record in this case, the Fourth Circuit determined that given the extensive discovery Harnett received in *Harnett I*,

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[6] The Fourth Circuit did not determine whether its decision would have been different if it applied Virginia law. (Pet. App. at A7, n.1.) In *Bate v. Devers*, 214 VA. 667, 202 S.E.2d 917, 921 n.8 (1974), the Supreme Court of Virginia looked to the Restatement (Second) of Judgments, § 61 Tent. Draft No. 1 to hold that "cause of action, for purposes of res judicata may be broadly characterized . . . ." *See also, Allstar Towing, Inc. v. City of Alexandria*, 231 VA. 421, 344 S.E.2d 903, 905-906 (1986) (citing and relying upon *Bate v. Devers, supra.*) Section 61 Tent. Draft No. 1 (1973), relied upon by the Supreme Court of Virginia, is the precursor to § 24, *Restatement (Second) of Judgments* (1982) and is identical to § 24.

it was impossible to say that any concealment, even if it existed, acted to prevent the assertion of Harnett's fraud claim during the pendency of *Harnett I*. (Pet. App. at A9-A10.)

The Petition thus misstates the record. Petitioner is disputing the Fourth Circuit's record determination based on the specific facts of this case, which has no general import or precedential significance in other cases.

CONCLUSION

For the foregoing reasons, the Court should deny the writ of certiorari.

Respectfully submitted,

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No. 86-1221

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

WILLIAM J. HARNETT,
Petitioner,

v.

TOM J. BILLMAN,
CLAYTON C. MCCUISTION,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

PETITIONER'S REPLY TO RESPONDENTS' OPPOSITION

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PETITIONER'S REPLY TO RESPONDENTS' OPPOSITION

PETITIONER'S REPLY

Despite respondents' contrary contention, this case squarely presents the issue of whether *Erie R.R. Co. v. Tompkins,* 304 U.S. 64 (1938), requires state preclusion law to govern the effect of a judgment in a prior federal diversity action on a subsequent diversity action between the same parties.

Respondents' opposition is founded entirely upon their assertion that petitioner's original EPIC action involved the dismissal of federal question claims. They argue that, in turn, the *res judicata* effect of the dismissal of federal question

claims—as opposed to diversity claims—should be determined by federal law. However, the order dismissing Mr. Harnett's first action dealt only with common law diversity claims. Thus it is respondents, not petitioner, who have distorted the record by characterizing the dismissal order in *Harnett I* as one involving federal question claims.

When petitioner Harnett's original EPIC action was settled and dismissed, the action was one arising solely out of common law claims and jurisdiction was based solely on diversity of citizenship of the parties. The only two counts remaining at that time were for common law fraud and for derivative harms to the corporation in the form of breach of fiduciary duty. (A34). Although Mr. Harnett's complaint in the EPIC action originally contained additional claims asserted under the district court's federal question jurisdiction and arising under federal statutes, those claims had been dismissed earlier in the case.

In *Harnett I,* the complaint expressly invoked the diversity jurisdiction of the district court under 28 U.S.C. § 1332. That action, brought by a Pennsylvania resident, against respondents and other parties, none of whom were Pennsylvania residents, originally included claims for common law fraud (Count I), declaratory judgment (Count II), RICO (Count III), federal securities laws violations (Count IV) and a shareholders' derivative action (Count V). On December 23, 1983, the district court dismissed Counts II, III and IV. (See District Court Order, December 23, 1983, attached hereto as Exhibit A). After this order, only the common law fraud claim and the shareholders' derivative action remained. Accordingly, the February 16, 1984 dismissal was that of a diversity action. (A34). It is the preclusive effect of that order, and only that order, that is in issue.

The present action, likewise, is solely a "common law fraud action," as the district court stated (A16), and the district court's judgment was solely for damages for common law fraud.

The Fourth Circuit recognized *Harnett I* as a federal diversity action. The court stated, "we conclude that whether a

federal court sits in diversity or has some other basis of jurisdiction, questions of the effect and scope of its judgment involve the power of the federal tribunal itself, and are not varied merely because state rules of decision underlie the judgment." (A7-8). Furthermore, obviously discussing the case at hand, the court, in a footnote, acknowledged that "in many cases, the issue of whether state or federal law governs a *res judicata* question arising out of a prior judgment entered by a *federal court sitting in diversity* is irrelevant, for often the state and federal rules on judgment will coincide." (A7, n.1) (emphasis added). The entire thrust of the Court of Appeals' opinion turns on the application of federal *res judicata* principles to the earlier federal diversity action.

In summary, the district court's jurisdiction over state law claims was not "pendent" to federal claims, as respondents maintain. All the federal claims were disposed of well before final disposition of the state claims, leaving an action based entirely on diversity jurisdiction. Accordingly, the issue presented by petitioner was properly framed, namely, the source of *res judicata* principles applicable in successive diversity actions. It is an important issue, because over 60,000 diversity cases are pending in district courts. Reports of the Judicial Conference, Report of the Administrative Office, U.S. Courts—1985, Table C2.

CONCLUSION

For the foregoing reasons, petitioner respectfully requests that his petition for a writ of certiorari be granted.

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EXHIBIT A

In The
UNITED STATES DISTRICT COURT
For The Eastern District of Virginia
Alexandria Division

Civil Action No. 83-1029-A

WILLIAM J. HARNETT,
Plaintiff,

v.

TOM J. BILLMAN, *et al.*,
Defendants.

ORDER

For the reasons stated from the bench, it is hereby ORDERED that:

1. The motion of the defendants to dismiss Counts II, III and IV of the Amended Complaint is granted.

2. The motion of the defendants to dismiss Count I of the Amended Complaint is denied, provided that the relief to which the plaintiff is entitled under Count I is limited to those damages arising from the alleged fraudulent prevention of the plaintiff from exercising his appraisal rights plus any punitive damages if an entitlement thereto is proved at trial. It is noted with regard to Count I that the defendants concede that they do not object to the plaintiff's exercise of those appraisal rights even at this time.

3. The motion of the defendants to dismiss Count V is denied.

/s/
United States District Judge

Alexandria, Virginia
December 23rd, 1983